

Shadow Economy and Economic Growth in Turkey

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Abstract As a developing country Turkey faces a shadow economy problem. After providing short literature review in our research, we will explain causes and consequences of shadow economic activities in Turkey. The main dynamics of economic development is depending upon economic growth. Thus, the paper will summarize recent paths of GDP growth and the volume of shadow economy.

Keywords Turkish economy • Shadow economy • GDP growth in Turkey

1 Introduction

Shadow economy is very complex issue to be searched and solved for both developing and developed countries with its causes, results and the working mechanism owing to its serious economic impediments. This overwhelmingly sophisticated part of this sector has many ramifications. So it has referred as hidden economy, second sector, informal sector, black economy and underground economy in different contexts. In general terms, shadow economy can be defined as monetary volume of the whole economic activities which cannot be measured and covered by official statistics. Shadow economy is the research area of many sciences such as economics, law, sociology, public finance and statistics. Thus each of those social sciences defines those activities according to its research area and agenda. For example, criminal framework is crucial in legal definition but the tax base and tax evasion has priority in public finance.

The definition and legal boundaries of shadow economy is also interrelated with geographical locations and cultural habits of countries. It can be systematic outcome of transformation to the market economy such as ex-communist countries where changing nature of production modes is not considered as shadow. In some countries, shadow activities are not personal income generating activities rather a collective conscious of the society. Portes et al. (1989) commented on Brazilian

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269

economy that favelas is a collective way of living in informal sector rather than individual utility maximization. The historical literature of shadow economy was first initiated to search with cause and effect relation of the sector. Further studies investigated the structural parts and focused to search monetary volume of the sector in GDP.

There is a high tendency that developed countries with strong economic performances have gradually low level of shadow economic activities. The estimation of volume of shadow economy enables us to see real values of many macroeconomic indicators and variables. The main reason behind the rise of shadow economic activities in developing countries is their intention to follow flexible labor and capital control policies in order to integrate global markets. Changing nature of competition in world markets force employers to make reductions in labor costs in order to improve profitability and productivity which can be achieved via flexible manufacturing systems. The political priority of contemporary governments must combat shadow economic activities. Shadow economy is directly correlated with income distribution in a specific country. Disadvantaged groups and people with low income prefer to supply their labor in informal sector in order to increase their benefits which in turn increases moonlighting and child labor.

There are two mainstream theoretical models for the explanation of shadow economic activities. First group of theories are mainly developed in western world and considers shadow economy as a main threat for well-functioning economic system. Under this framework politically correct developed countries, budget revenues and expenditures with other macroeconomic indicators are very reliable parameters for future estimations. Increasing shadow economy reduces the main sources of public finance for education and health expenses in developing countries and creates welfare loss (Johnson 1989). The shanty towns in mega cities have poor facilities for education and human development that they cannot find suitable position in formal job market in urban areas (Mitra 1994). Some western academics projected on GDP levels in transition economies that are higher than real figures due to shadow economy and macroeconomic variables would be unreliable (Feige 2008).

Second approach originated from Latin American countries has the assumption of positive impacts of shadow economic activities as a tool for economic growth and stability. They argue that shadow economy creates innovative production process in private sector in spite of conservative, giant state bureaucracy and red tape (Anderson 1998). The reflection of that perception in politics is lax measures to combat shadow economy. Latouche (1993) considered shadow economy as a crucial part of formal economy and commented its inevitable share in world economic order. De Soto (1988) defined shadow economy as a rising power of middle class entrepreneurs against dictator rulings in Latin American countries.

In global perspectives, one can easily differentiate those countries with the outcomes of poor development level and low economic growth rates. Countries with low share of shadow economy to GDP ratio have good economic development record with high per capita income. Contradictory to that low GDP per capita accompanied with high share of shadow economy.

2 The Causes of Shadow Economy

There are different drives behind shadow economic activities in Turkey. We can explain them under three different sub categories. Those drives are explained in details as follows.

2.1 *Economic Drives*

These are mainly driven by supply demand relations under the market conditions. Economic actors try to avoid some regulations by operating in shadow economy for profit maximization. Government economic policies, foreign trade regime, inflation rate and unemployment level are the main factors. The outsourcing and subcontracting in manufacturing process is one of the drives in developing countries. In Turkey, companies with high scale production are subcontracting some parts of manufacturing chains to independent small firms out of the main production plant in order to reduce production costs (İkiz 2000). Textile producers and construction companies are subcontracting most of the production process. Those small subcontractors can easily get off the hook from state inspection and avoid taxation process.

The price instability and volatility in markets increases uncertainty and riskiness of business life. In order to reverse the burden of possible loses, companies prefer to hide official transactions from public inspections. High volatility in market, forces buyers and sellers to deal and exchange in shadow sector in order to get rid of riskiness of price volatility.

Improper and unpredictable economic policies of policy makers are crucial element for shadow economy. Political decision makers may change taxes and public expenses in different terms of governments. That will affect public sector borrowing rate, tax ratios. In most of the cases, if policy vector aims to boost monetary base faster than economic growth, it creates fiscal and monetary instability and increases the volume of shadow sector. In many cases weak financial sources of state expenses may boost shadow sector. Nation state budget shows annual expenses and revenues of governments in detailed explanation. Governments may choose to finance state expenses and investments without tax collection such as borrowing and central bank sources. The direct implications of those policies are demand pull inflation and booming of shadow sector.

Short term shadow capital inflow creates excess demand in national income without generating increase in production level and total supply. Speculative foreign monetary inflows (hot money) reached enormous amounts in today's globalized world. Low exchange rates with high yield of interest rates attract those funds to Turkish economy. Most of the speculative financial investments are funded by shadow foreign resources. It is quite obvious that most of that capital inflow is not shown in official statistics that the Turkish balance of payments has

huge amount of errors and omissions which reveals inflow of unrecorded financial resources to country. Thus whole process creates shadow economic activity.

2.2 *Fiscal Drives*

In developing countries public sector service quality and efficiency is creating pressure on economic life. Poor public sector infrastructure, discrepancies in state revenues and expenses, public sector functioning parameters can be classified as main reasons. Public finance authority and tax collection process sometimes would not be quite simple and must be reorganized.

Organization of taxation authority would be insufficient and ineffective to combat shadow economic activities. State bureaucracy in taxation process is not quite effective in Turkey. Applications of indirect taxation, tax exempt for petty traders and small artisans are eroding tax base. Shallow tax base harms tax collection capacity. Turkish public finance is heavily based on indirect taxes on energy and communication sector products. The high share of indirect taxes to direct taxes in whole economic structure diminishes taxation and increases shadow economy.

State expenses and revenues out of budget restrictions is another fiscal drive for shadow economy. Government agencies are creating their own revenues besides budget restrictions. Creation and establishment of those special funds, foundations for special purposes in governmental institutions increase shadow economic activities of state without budgetary controls.

2.3 *Sociological Drives*

Even if sociological superstructure is interconnected with economic infrastructure, the unique social patterns of cultural codes of each country woven with its own geographical historic roots. That impacts the informal sector volume in those countries. For example, the number of shanty areas and settlements has very material impact on shadow economy. Shadow economic activities and informal sector can be the result of sociological superstructure change in society. The urbanization in Turkey has radically increased since 1950s. The main outcome of that spontaneous policy choice is mega cities with poor infrastructure and employment opportunities.

Internal migration and unplanned urbanization is a key element in moonlighting. Disguised unemployment and low income are the main causes of internal migration to cities from rural areas for years in Turkey. The terms of internal trade rise against agricultural sector for years. That seriously hampered the income level of farmers and created internal migration. Those migrants constructed shanty villages at the edge of urban areas those mega cities. The main function of those settlements is to

act as bumper mechanism for newcomers to integrate to center from peripheral parts of the town. The newcomers serve as inexpensive labor force for different parts of the city informally. Exceedingly population rise increases labor supply and sometimes could not be matched by demand for workforce. High population growth may create unemployment when it is not absorbed with an increase in investment level which in turn increases informal unemployment. Unemployed masses become the main pool for informal employment. Low paid workers without social security creates social disorder in different segments of society. That may impose high public unrest with social violence as recently happened in Arab countries.

Deformation in moral values is the core source for shadow economy. State citizens are bounded by some moral codes and ethics which are not written or legislated. As long as citizens are willing to obey those social codes and rules without any hierarchical sanctions, the social ties are utterly constructed and there is not crisis of confidence among citizens and state. The perfect case is Anglo-Saxon and Scandinavian countries where people do have high confidence on each other. Even though nation state is always conceptualized as sacred phenomena in eastern cultures, there is a high record of disobedience to written laws, moral codes and regulations. In western societies, there are few attempts to disregard to activities of tax authority. In contrary countries in Middle East are very reluctant to perform their duties to tax authorities.

3 The Outcomes of Shadow Economy

Shadow economic activities have important outcomes on macroeconomic activities in Turkey. The political, economic and social layers in society are radically affected by the informal sector activities. Those outcomes create harmful impediments to the economic growth and development efforts of countries. Firstly shadow economy distorts free market economy by creating unfair competition. Companies operating in shadow sector have low cost advantages in production process of goods and services compared to formal companies. In this case, companies with perfect record of tax payments, social security payments and other official requirements will face with unfair competition. Also companies in formal sector use much more innovative production techniques and they are very competitive in world markets. Increase in shadow economic activities in companies create dualist economic structure in Turkish economy where companies with western standards in formal sector and unregistered informal companies produce under the same market conditions. Since both conservative unregistered and contemporary formal companies operate in same country, former has unfair cost advantage against later owing to the poor working conditions with low payments in informal sector. This pattern and production process in dualist model is not sustainable and borne to social unrest and high social violence.

Main source of public finance for state expenditures are compulsory transfer of partial income of country citizens to state authority by taxes. That is the financial

source of nation state public expenditures. Unregistered economic activities of companies create redundancy in revenue declaration to tax authorities. Shadow economy shrinks tax base and hampers tax revenues. That triggers budget deficits in country which has inflationary effects. Also tax evasion efforts of individuals and companies decrease budget revenues which are the essential parts of public finance. The main functions of welfare state cannot be maintained without those incomes. The low level of tax revenues threatens budget resources for education and transfer payments for disadvantaged groups from lower segments of society. Shadow economy exterminates public consensus for state of law. The citizens of nation state have equal rights and duties. One of the main duties is tax levy which is the most important source for public finance. Increasing volume of shadow activities increases tax evasion and hampers income distribution. Unfair income distribution is main threat to public consensus. For sure public consensus in countries is main pillar for well-functioning democracy.

Reliability of statistical data becomes very vulnerable with shadow economic activities. Macroeconomic variables are the main source of analytical device for political decision makers. If gathered data does not reveal correct figures and tendencies, main macro-economic variables such as inflation and economic growth can be misinterpreted with policy implications. For example, if economic policy makers have inflation rate figures less than real values, expansionary monetary policy will create fiscal disorder and inflationary spiral.

Moonlighting in informal sector has serious impediments on social security system deficits. Informal employment reduces compulsory social security payments by employers and hampers social security companies' assets. Insufficient assets of those institutions create financial weakness in social security companies. This, in turn, affects the whole social security system. Shadow economy has adverse effects on economic growth. Even if informal sector increases gradual employment in short term, in long term, it dampens robust economic growth. Most of the production and employment in shadow sectors are not very productive and inefficient. Production technologies are old fashioned and energy consuming that they are not high income and profit generating with low value added products. Thus whole performance of country in macroeconomic level cannot reach robust economic growth. Low economic growth also increases informal employment and shadow economy. During the economic crises, slow growth rate and declining national income increases shadow economic activities. In 1994 and 2001 economic crises, the volume of shadow economic activities peaked half of the national income in Turkish economy.